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Supreme Court of the United States

OCTOBER TERM, 1969

No. 1135

VICTOR MUSCAT and R. L. HUFFINES, JR.,

Petitioners,

against

NORTE & CO.,

Respondent.

REPLY BRIEF IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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Replying to Point I—First Question (Resp. Br., pp. 10-19)

The suggestion that the questions posed in the petition for certiorari are "hypothetical" is frivolous. To say that the difference between a judgment for $625,038 (which we contend is the limit of liability) and a judgment of $3,777,346 is "hypothetical" is to miss the issue completely.

Respondent fails to discuss the basic questions. We claim that where there is a *practical merger,* the only harm that results from an over-valuation of securities on one side of the exchange is to the minority stockholders who suffer dilution of their proportionate equity and not to the corporate entity itself. Despite its citation of a case

like *Hooper* v. *Mountain States Securities Corp.*, 282 F. 2d 195, 203 (5th Cir. 1960), cert. den. 365 U. S. 814 (1960), cited in our petition, page 16, respondent nowhere discusses whether there is a difference between the sale of worthless property to a corporation for shares, as in *Hooper,* and the case at bar where there has been an exchange of shares, resulting in an acquisition of 100% of the acquired corporation. Significantly, no case is cited by the respondent in which 100% of the stock of one of the companies in the exchange has been acquired. In such case, the true loss is that of the non-controlling stockholders who have suffered a dilution of their equity, and is not that of the acquiring corporate entity itself. Whether the acquired corporation (IIE) had been actually liquidated into the parent immediately after its acquisition or not there still is merely an unfair rearrangement of the *equities of the stockholders.* That is what should be redressed. The argument that our position would imply that recovery in "the derivative action would rarely, if ever, go to the corporation" (Resp. Br., p. 14) is simply not correct. On the contrary, in cases where there was actual damage to the corporate entity as in the ordinary cases of waste, the derivative action lies on behalf of the corporation. We ask that equity be held not to permit an award of "damages" to stand which is a windfall.

We must emphasize that neither in its brief below nor in its present brief does the respondent challenge the cardinal point that the minority stockholders of Defiance (other than the defendant controlling stockholders of Defiance) lost only $625,038 (Pet., p. 5) instead of $3,777,346, the amount of the judgment (A70-71). The controlling stockholders, the alleged wrongdoers, moreover, would regain their aliquot portion of the judgment on behalf of the corporation only if they had retained their shares and were sufficiently wealthy and liquid to pay the full amount of the enormous judgment and recoup it indirectly through their continuing stock ownership in the corpora-

tion. The respondent also fails to answer the point that the recovery to the corporation results in a double windfall to the minority stockholders of IIE, the acquired corporation. They have already had one windfall, according to the Court's finding. Now they will obtain another if they have held on to their stock in Defiance. The recognition that the defendant controlling stockholders would share in the recovery if they held their stock shows the fortuitous nature of the remedy provided by the Courts below. We believe that the only proper relief in this situation is to require a payment of the actual loss to the minority stockholders who relied upon the alleged false proxy statement. The judgment below is certainly grossly in excess of the true measure of the actual loss suffered.

Moreover, it is far from "obvious", as respondent mistakenly contends, that "if defendants had paid fair value to Defiance, it would have in its treasury the amount which *they* pocketed" (Resp. Br. p. 13; emphasis ours). The fact is, and it was uncontested below, that petitioner's paper profit on the Court's own figures was only $740,295, since if the acquisition of IIE stock by Defiance was a "lemon", the petitioners by receiving Defiance shares in the exchange acquired their share of the "lemon".*

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* Prior to the acquisition there were 221,225 shares of Defiance outstanding (Ex. 1, p. 9). At the Court's figure of $14.49, this gave a net worth to Defiance of $3,205,550. Muscat, Huffines and Krock owned 44,300 shares of Defiance (420,157 less 375,857—51a). This was an equity for them of $641,907. The total value of IIE again at the Court's figure of $40.58 per share for the outstanding 99,998 shares was $4,056,296. The Muscat group owned 77.1% (Ex. 1, p. 9) of IIE giving them an equity of $3,127,404. Their combined equity in the two companies before Defiance acquired IIE was therefore, $3,769,311.

After the acquisition the group owned 62.1% of Defiance (30a) Since the combined value of the two companies, under the Court's opinion was $3,205,550 plus $4,056,296 or $7,261,846, the equity of the group was now, therefore, 62.1% of the combined figure, or

(*Footnote continued on following page*)

The respondent is also in error when it says that there is no issue respecting the fashioning of equitable remedies by the Federal Courts on state causes of action (Resp. Br., p. 9). The action in suit seeks an accounting for alleged breaches of fiduciary duty, among other things. Indeed, the Court in *Ross* v. *Bernhard,* No. 42 (decided February 2, 1970) specifically excludes from its holding that the plaintiff in a derivative suit for damages has a constitutional right to a jury trial cases where, as in the instant case, breach of fiduciary duty is alleged. Respondent concedes that "equitable principle" is involved (Resp. Br., p. 7). We contend that so far as the Federal cause of action is concerned—arising from the alleged violation of the proxy rules—the Federal Court, as we have pointed out, should do equity by not increasing the judgment to a sum *more than four times* as much as the minority stockholders actually lost. We contend, moreover, that with respect to the state causes of action based upon diversity of citizenship, the Federal Courts similarly have a duty to mold equitable remedies to do justice and that they are not bound by the remedies of State law. *Guaranty Trust Co.* v. *York,* 326 U. S. 99, 105 (Pet. pp. 17-23). In short, the Federal Courts should be instructed by this Court that in granting relief they must "prevent unjust enrichment". *Southern Pacific Co.* v. *Bogert,* 250 U. S. 478, 497 (1919). The Federal Court with jurisdiction over a State law cause of action should mold its decree to do fundamental justice with respect to the state causes of action as well. We submit that the Federal Courts should not feel bound to apply state law remedies.

The importance of the issue here involved is that in the growing area of litigation by minority interests in Fed-

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(*footnote continued from preceding page*)

$4,509,606. The paper profit was the difference between their former equity of $3,769,311 and their present equity of $4,509,606, or $740,295.

The District Court was clearly erroneous when it found petitioners to have profited by $2,703,910.

eral Court, justice and fair play require the judicial recognition of guide lines to prevent excessive and unjust recoveries.* While the pendulum has swung far in behalf of minority rights, as is proper, the warning of Mr. Justice Brandeis should be borne constantly in mind—Courts of equity should "prevent unjust enrichment."

Replying to Point I—Second Question (Resp. Br., pp. 19-23)

Respondent's argument that the Courts below did not ignore the pre-trial order is untenable. The pre-trial order was more than a recital of a market price per share. It stipulated that "Defiance issued 487,502 shares of its Class B stock, having a market value of $5,677,211." It stipulated that the facts in the pre-trial order were not in dispute (132a). The respondent itself, in its amended complaint, alleged that at the time Defiance was caused to acquire the outstanding stock of IIE as aforesaid, the shares of stock of Defiance had a "fair and reasonable value" of $11.50 per share (13a). The total "fair and reasonable value" was $5,606,263 (487,502 shares x $11.50). This is almost the same as the stipulated market value of $5,677,211 in the pre-trial order. The amended complaint was repleaded subsequent to the pre-trial order and after

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* Respondent's argument (Br. p. 17 fn.) that "to 'by-pass' the corporation would inevitably lead to a hornet's nest of litigation" is unfounded since the further question of which shareholders should get the recovery are questions of law to be decided by the Court—with the aid of computerized stock transfer sheets. Indeed, even if these questions should impose mechanical problems, they are no different from the problems posed by any other class actions which are liberally encouraged by Rule 23 of the Federal Rules of Civil Procedure and which are particularly important in enforcing the Securities Laws. Thus, the contention that enforcement of the Securities Laws would be seriously undermined (Resp. Br. p. 16) by permitting recovery to Defiance's independent shareholders is also without foundation.

the trial had begun. In the face of this, it is disingenuous to argue that the pre-trial order did not establish the agreement of the parties with respect to the fair and reasonable value of the Defiance shares.

No evidence was offered by the defendants with respect to the value of the Defiance shares. It could hardly be expected that they would offer any such evidence in the face of the purportedly binding pre-trial order. If the question of market value had been open the defendants could have proved that at the time of the actual exchange of stock the Defiance shares had fallen to about $8 a share, considerably less even than in the pre-trial order (137a). We also point out with the greatest respect for the trial Judge below that it was on his own motion after trial (which is not denied by the respondent) that Judge Mansfield sought material as to the volume of trading. He had not referred, in any way, to the market value in the pre-trial order in his first opinion. He then used the new material to cast doubt on the validity of the pre-trial order previously entered. It is against this that we complain. Indeed, calling for additional evidence was clearly contrary to the general tenor of the rule in the Tenth and other Circuits that "[t]he trial court may not disregard the facts stipulated to *or require evidence to support them.*" *U. S. v. Sommers,* 351 F. 2d 354 (10th Cir. 1965; emphasis ours; Pet. p. 24). We urge that it is a matter of the utmost importance in the conduct of Federal litigation for litigants to know that pre-trial orders, unless timely relief from their terms is obtained, are binding. Otherwise they are not merely useless but may be a trap for the unsuspecting. The distinguished Second Circuit itself recognized this in *Mull v. Ford Motor Co.,* 368 F. 2d 713 (1960), but disregarded the matter in considering the appeal herein, for what reason does not appear.

We urge that this Court, as supervisor of the procedure in Federal Courts, should not condone practice which ob-

viously will encourage lawyers to try every issue of fact—even those which are the subject of a stipulation in a pretrial order—defeating the very purpose for which Rule 16 was promulgated.

Replying to Point I—Third and Fourth Questions (Resp. Br., pp. 23-26)

The main reason for the conclusion that the petitioners are liable arises from the claim that there was an inflation in the Nablico earnings figures. It is quite clear from the record that the issue involved certain post-year adjustments of the earnings of the insurance company as they had been reported to the State Commissioner of Insurance of Texas. There is no doubt that the proxy statement used the same figures that were given to the Insurance Department of Texas. The basic difference was that post-year adjustments, as is customary in State insurance accounting, were entered directly to the surplus account rather than through the income account. No figure was concealed from either the SEC or the stockholder. The SEC staff and its accounting experts saw all the entries involving these post-year adjustments and also saw that they were in the surplus account rather than in the income account. Respondent does not claim the contrary. The SEC even suggested some changes in the surplus account, indicating that the treatment of the rest of the account was unexceptionable. We contend that in such circumstances of open disclosure there was no direct proof of fraud or scienter and that the standard imposed upon the laymen defendants with respect to accounting matters was too rigid in view of the SEC's own acceptance of the figures.

We rsepectfully suggest that the other alleged omissions or misstatements might not have been deemed material were it not for the Court's erroneous view of the accounting problem.

Replying to Point I—Fifth Question (Resp. Br., pp. 26-27)

We know of no rule which would prevent this Court from granting certiorari on matters involving the fairness of an exchange. See, for example, *U. S.* v. *ICC, Brundage* v. *U. S.* and *Livingston Anti-Merger Committee* v. *ICC* (Nos. 25, 38, 43 and 44). In any event, we have suggested that the Court should grant certiorari on the earlier points briefed and that if certiorari is granted, the Court should not limit its grant, but should also consider the fairness of the exchange.

CONCLUSION

For the foregoing reasons petitioners pray that a petition for a writ of certiorari in this case be granted.

Respectfully submitted,

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